FEDERAL INCOME, ESTATE, AND GIFT TAX ISSUES AND PLANNING CONSIDERATIONS FOR DOMESTIC PARTNERS

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I. Defense of Marriage Act, a.k.a. "DOMA" (Pub. L. 104-199, 100 Stat. 2419 (1996))

A. **Section 2 of DOMA (28 U.S.C. § 1738C)** – no state or territory of the United States must recognize a same sex marriage from another state or territory.

B. **Section 3 of DOMA (1 U.S.C. § 7)** – for purposes of federal law, "marriage" is defined as between one man and one woman, and "spouse" is defined as a person of opposite sex who is a husband or wife.

II. Income Tax Issues

A. Filing Status

1. **Tax Returns** – Domestic partners must each file individual tax returns and may only file as single or head of household. If the income of partners is approximately equal, this is likely a tax advantage. *See* I.R.C. §§ 1, 2.

2. **Spousal IRA Contributions** – A non-working spouse may contribute up to $5,000 to an IRA based on the income of the working spouse if a joint tax return is filed. I.R.C. § 219(c). Unavailable to domestic partners.

B. **Health Insurance** – *see* I.R.C. §§ 105, 106; Treas. Reg. § 1.106-1

1. Assuming benefits are provided to a non-dependent domestic partner by an employer, the value of the benefit is included in the gross income of the employee.

2. Employee cannot use pre-tax dollars (e.g. FSA, HRA, HSA) to pay for non-dependent domestic partner's health insurance premiums or health care bills.

3. Employee must pay income tax at employee's marginal rate on the imputed income from any health benefits received for a domestic partner, in addition to increased medicare tax, and to the extent applicable, social security tax.

C. Childbearing Expenses

1. Fertility treatment for an individual may be deductible as a medical expense by that individual. I.R.C. § 213.

2. Other costs (e.g. costs associated with a surrogate) may not be deductible by either domestic partner. *See* I.R.S. Info. Ltr. 2002-0291 (Aug. 12, 2002); *see also Magdalin v. Comm'r*, T.C.M. 2008-293.

D. Inter-partner Property Transfer

1. May have recognition of gain or loss, even if incident to divorce. *See* I.R.C. § 1041; *United States v. Davis*, 370 U.S. 65 (1962).

2. Gain from sale or exchange of personal residence exclusion is limited to $250,000. I.R.C. § 121.

E. Alimony

1. No deduction for alimony paid. *See* I.R.C. § 215.

2. Receipt of alimony is likely not income. *See* I.R.C. §§ 61, 71.

3. Trust income used to pay alimony and normally taxable to payor is included in the gross income of the payor. *See* I.R.C. § 682.

III. Estate and Gift Tax Issues

A. Spousal Gift Tax Exemption – Transfers of property to a spouse are not taxable gifts. I.R.C. §§ 2503(a), 2523.

1. Any transfers to a domestic partner beyond the annual exclusion amount ($13,000 for 2009) constitute taxable gifts. I.R.C. § 2503(b).

2. Transfers include both direct and indirect transfers and may include gifts of luxury items and unequal payment of living expenses. I.R.C. § 2511(a).

3. May be considered gift, even if incident to divorce. *See* I.R.C. § 2516; *but see Harris v. Comm'r*, 340 U.S. 106 (1950) (excluding from gift tax transfers pursuant to a court decree).

B. **Spousal Estate Tax Exemption** – Transfers of property to surviving spouse are generally deducted from decedent's gross taxable estate. I.R.C. § 2056.

1. Transfers by a decedent to a domestic partner are included in the decedent's gross taxable estate and are not eligible for the marital deduction.

2. Property Owned as Joint Tenants / Tenants-By-the-Entireties – I.R.C. § 2040

   a. For spouses who are both U.S. citizens, only one-half of the property is included in the decedent's estate. I.R.C. § 2056(d).

   b. Unless domestic partners show through documentation the portion of the property owned by each domestic partner, the entire portion of the property is presumed to be included in the decedent's estate.

C. **Generation-Skipping Tax** – Spouses are always in the same generation for purposes of GST, but if domestic partners have an age difference of more than 12.5 years, they will be in different generations. I.R.C. § 2651.

D. **Federal Property Rights** – To compensate for a lack of survivor benefits, life insurance can be purchased for the benefit of non-titled domestic partner in the event that the titled domestic partner predeceases the non-titled domestic partner.

1. **Social Security** (42 U.S.C. § 402)

   a. Spousal benefits

      (I) Spouse is generally entitled to benefits equal to one-half of other spouse's benefits (subject to reduction by spouse's own entitlement).

      (II) Unavailable to domestic partner.

   b. Survivor benefits

      (I) Generally equal to decedent's benefits (subject to reduction by spouse's own entitlement).

      (II) Unavailable to domestic partner, but children may be entitled three-quarters of decedent's benefit.

      (III) Survivor benefits from prior opposite-sex marriage will not be terminated by entering into same-sex domestic partnership.

c. Death benefit of $255 – Unavailable to domestic partner, but children may be entitled to it. 42 U.S.C. § 402(i).

2. **Veteran's Benefits for Surviving Spouse** – likewise unavailable to domestic partners.

3. **Pensions**

a. Federal Employees

(I) Domestic partners are not entitled to survivor annuities under either the Federal Employees Retirement System ("FERS") or the Civil Service Retirement System ("CSRS"), but children may be. 5 U.S.C. §§ 8341, 8442, 8443.

(II) Under FERS, employee may designate, at the time of retirement, domestic partner as the beneficiary of an insurable interest annuity in exchange for a reduced annuity amount ranging from 10% to 40%, depending on the age differential between employee and beneficiary. 5 U.S.C. § 8420. If beneficiary predeceases employee, annuity is recomputed as if annuity had not been so reduced. *Id.* Beneficiary's annuity begins at employee's death and will be 55% of the reduced annuity. *Id.* § 8444.

(III) Under FERS, if no one qualifies for a survivor annuity (including an insurable interest annuity as described in (II) above), domestic partner may be designated as the beneficiary of the lump-sum credit on which the unpaid portion of the annuity is based. 5 U.S.C. § 8424.

(IV) Similar rights available to domestic partner under CSRS. *See, e.g.*, 5 U.S.C. § 8342.

b. **Employees of Private Employers** – ERISA mandates that spouses have certain rights in order for a defined benefit plan to be qualified. *See* 29 U.S.C. § 1055. A plan may permit domestic partners to have similar rights, but if the plan does not so provide, a domestic partner has no recourse.

(I) Qualified Joint and Survivor Annuity (QJSA) – an annuity for the life of the participant with a survivor annuity for the life of the spouse which is between 50-100% of the amount payable during the joint lives of the participant and the spouse.

(II) Qualified Pre-retirement Survivor Annuity (QPSA) – an annuity for the life of the surviving spouse, if participant dies before the retirement date.

c. Elections that effectively "share" an annuity with a domestic partner result in a taxable gift to that partner and the value is included in the deceased partner's taxable estate at death. *See* I.R.C. §§ 2039, 2523(f)(6); I.R.S. Priv. Ltr. Ruls. 8811017 (Dec. 16, 1987), 8721013 (Feb. 13, 1987).

4. **Long Term Care Insurance for Federal Employees** – Office of Personnel Management published proposed regulations extending definition of "qualified relative" to include same-sex domestic partners, making long-term care insurance available (74 Fed. Reg. 46,937, 46938 (Sept. 14, 2009)).

E. **No "Split Gifts" From Domestic Partners** – I.R.C. § 2513.

F. **Medical Expenses** – Although one generally cannot receive a deduction for medical expenses paid on behalf of a domestic partner, such payments are not considered gifts. I.R.C. §§ 213, 2503(e).

G. **Educational Expenses** – Although one generally cannot receive a tax credit for educational expenses paid on behalf of a domestic partner, such payments are not considered gifts. I.R.C. §§ 25A, 2503(e).

H. **Planning with Split-Interest Trusts**

1. Value of the retained interest in a trust when an interest is transferred to a "member of the family" may be deemed to be zero if the transferred interest is not qualified. This rule does not apply to a Qualified Personal Residence Trust (QPRT). I.R.C. § 2702; Treas. Reg. § 25.2702-5.

2. A qualified interest is defined as:

a. any interest which consists of the right to receive fixed amounts payable not less frequently than annually,

b. any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually), and

c. any noncontingent remainder interest if all of the other interests in the trust consist of interests described in (a) and (b) above. I.R.C. § 2702(b).

3. Domestic partner is not a "member of the family." I.R.C. § 2704(c)(2).

4. Example of tax planning that takes advantage of these rules. A domestic partner (P1) sets up a grantor retained income trust owning his personal residence, but trust fails to qualify as a QPRT. The other domestic partner (P2) is the remainder beneficiary of the trust. At the time the trust is established, the value of the gift to P2 is discounted by the present value of the interest retained by P1. Near the end of P1's term, P1 repurchases the residence from the trust at the full market value of the residence. The effect of the transaction is that P2 receives money equal to the value of the residence, plus the appreciation of the residence over P1's term of the trust, while only utilizing a portion of P1's unified credit equal to the present value of P2's future interest at the time the trust is established. An additional benefit of this transaction over a QPRT is that when the property is ultimately transferred at P1's death, there will be a step-up in basis. *See* I.R.C. §§ 1014, 1015.

I. Grantor Retained Annuity Trusts (GRATs) – Attractive option when interest rates are low, but if GST is applicable, the grantor's GST exemption may be wasted.

J. Comparison of Basic Estate Plan of Married Couple to Domestic Partners

1. **Married Couple** – Each spouse sets up a credit shelter trust such that the survivor will not have to include the trust in his or her estate. Each credit shelter trust is funded with the maximum amount permitted under the unified credit, with the remainder going into a marital trust, which will be included in the survivor's estate. This maximizes the use of each spouse's unified credit without having to pay any estate tax until the death of the surviving spouse.

2. **Domestic Partners**

   a. Tax considerations. Each partner sets up a trust such that the survivor will not have to include the trust in his or her estate. Generally, everything a partner owns will go into the trust. This maximizes the use of each partner's unified credit and prevents the assets from being subject to estate tax twice.

   b. Non-tax considerations. As a practical matter, the domestic partners may have other considerations aside from tax considerations that might make the above plan undesirable. For example, an interest in a shared personal residence might be transferred outright to ensure that the surviving partner has complete control over the property or to facilitate the exclusion of the appreciation in value of the residence from taxable income. Additionally, it is not uncommon for same-sex domestic partners in particular to have family members who might be named remainder beneficiaries of a trust that disapprove of the other

partner or the nature of the domestic partners' relationship. In such an instance, a remainder beneficiary may cause problems for the surviving partner that the settlor would like to avoid, such as preventing assets of the trust from being distributed for the benefit of the domestic partner pursuant to an invasion of principal power limited by an ascertainable standard. *See* I.R.C. § 2041.

IV. Current Challenges to Section 3 of DOMA

A. *Gill v. Office of Personnel Management*, No. 1:09-cv-10309 (D. Mass. filed Mar. 3, 2009) – challenges ability of couples married under state law to file joint tax returns, receive social security benefits, receive benefits under CSRS, and receive health insurance benefits under Equal Protection Clause of 5th Amendment.

B. *Massachusetts v. U.S. Dep't of Health & Human Servs.*, No. 1:09-cv-11156 (D. Mass. filed July 8, 2009) – challenges DOMA under 10th Amendment and Spending Clause.